Accounting Cycle

The Fundamentals of Accounting

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- Recognize the importance and process of preparing proper financial statements.
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- Prepare a balance sheet (also known as statement of financial position) from a Trial Balance.
- Identify a cash transaction as an operating activity, investing activity, or financing activity.

Important components of financial accounting

Understand the system of managing and recording the following:

- Cash & Bank,
- Receivable Balances,
- Inventory,
- Non-current assets,
- Payroll systems.

UNIT 1: ACCOUNTING CYCLE

1.1 Assumptions of financial accounting

All book-keeping and accounting is based on some well-defined and universally accepted principles. They are alternatively named in the accounting literature. Some names are given as below:

- **Postulates**
- **Doctrines**
- **Concepts**
- **Conventions**
- **Tenets**
- **Principles**
- **Bases**
- **Assumptions**

Brief description of these fundamental principles and their underlying characteristics is given in the paragraphs given as **1.2** and **1.3**.

1.2 Characteristics of financial accounting & reporting information

- **Relevance**
  Information provided by an Accounting System must be pertinent to the financial status and performance of the company.

- **Understandability**
  To be useful, accounting information should be understandable to its users. Proper means of communication, including use of terminology, generally accepted lay-out of the financial statements, adherence to professional and industry disclosure requirements enhances the acceptability of the information presented in the financial statements.

- **Verifiability**
  All the accounting information should be verifiable for the genuineness.

- **Objectivity**
  Accounting information should be neutral in the sense that data are not manipulated to favour one party over another. This concept includes that all transactions will be recorded on the basis of objective evidence (i.e. invoices, receipts, bank statements, cheques etc.). For instance, a report is said to be objective, when two or more accountants arrive at same answer to an accounting query.

- **Matching**
  For any period in which revenue is recognized, expenses incurred in obtaining that revenue should also be recognized. For instance, sales price of merchandise is matched with its cost on sale to third party.

- **Timeliness**

For information generated by the accounting system to be useful for decision – making, it must be received by the stakeholders soon after the close of the financial year. Any delay in producing and presenting of financial statements would badly affect the decision making capability of the company. It is because of this principle that all companies' laws in the world provide time frame for the production and presentation of this information.

- **Consistency**

This principle refers to the use of the same accounting method from one reporting period to another, so that proper evaluation could be possible over the periods of time.

- **Comparability**

Financial reports/statements must be presented in a form that permits comparison with other companies in the industry on equal basis. For instance, if all companies in an industry apply IFRSs/IASs in the preparation of their financial statements, their comparison can be made easily.

1.3 Principles of financial accounting & reporting

- **Disclosure**

All information which would influence the assessment of the company's health by outsiders should be disclosed in the financial statements.

- **Conservatism/ Prudence**

This principle can be understood from the following, **'Record all losses when incurred and defer all gains until they are realized'.**

- **Separate Entity Concept**

Business accounting and reporting is separate from the other personal properties and other businesses of the owner.

- **Continuity/Going Concern Assumption (GCA)**

The business is assumed to continue its operations for indefinite periods.
[***Refer to the detail at Unit 9***]

- **Stable Monetary Unit (SMU)**

It is assumed that prices remain constant over time. Financial Statements are prepared from historical cost rather than on current values of assets.

Accounting Period
This concept refers to the time span over which accounting information is presented to the stakeholders in the form of financial statements. It also refers to **the periodicity concept,** which says financial statements are to be presented on periodic basis, mostly on Quarterly or Annual basis.

❍ **Money Measurement**
All transactions are expressed in terms of a monetary unit of a country, the company is operating. All financial statements are presented in the currency of the country, which is also known as reporting currency. For instance, all companies working in **UAE** record their transactions in Dirham and all companies working in **USA** use Dollar as their reporting currency.

❍ **Substance over Form**
It is an accounting concept where the entity is accounting for items according to their substance and economic reality and not merely on their legal form. **This concept is one of the key determinants of reliable information.** For most transactions, there will be no difference, so no issue arises. In some cases however, the two diverge and the choice of how to present the transactions can give very different results. This difference occurs when an asset or liability is not recognized in the accounts even though benefits or obligations may result from the transaction, or oppositely. For instance, a contract for acquisition of an asset that is legally a lease may, in fact, equivalent to purchase. To more elaborate this example, a company acquired an asset through lease arrangement and agreed to make annual lease payments. Though on papers this is a lease of the asset but in economic substance and financial reality it is acquisition of the asset. The company after making a nominal payment to Lessee Company can acquire the asset. Since the lease term covers substantial part of the life of the leased asset.

Here the economic substance of the transaction is Purchase rather than Lease; therefore its depreciation will be booked instead of showing rental expense in Profit & Loss Account.

Remember this line: **Accountants record a transaction's economic substance rather than its legal form.**

Materiality
Accountants record only those events that are significant enough to justify the usefulness of the information. Technically speaking, each time a sheet of paper is used, the current asset, '**Office Supplies**' is decreased by an infinitesimal amount but the transaction is not material enough to be recorded and accounted for. So this transaction is immaterial from accounting point of view and is not booked. Only material transactions are recorded.

❍ **Dual Aspect**
This concept is the basis of the fundamental accounting equation, which is:

Assets = Liabilities + Capital

According to this concept every business transaction has **two recording aspects**. One is known as Debit (**Dr**.) and the other is known as Credit (**Cr.**). This concept is the foundation of Double Entry book-keeping. It is because of this concept that the two sides of a balance sheet always agree.

❍ **Historical Cost Convention**
Historical cost convention is that assets are recorded at their initial cost and are not subsequently revalued upwards, and liabilities valued at the amount initially received in exchange for the obligation. The relevance of the convention is that figures remain objectively based on verifiable conditions, but in times of high inflation historical cost can become a dubious convention to follow.

❍ **Cash Basis versus Accrual Basis of Accounting**
The Cash basis of accounting recognizes revenue and expenses only when the related cash is received and disbursed. Thus income and expense recognition of a transaction is dependent on cash received and disbursed. Under accrual accounting, revenue is recognized when earned and expenses are booked when incurred. Almost all companies use accrual basis of accounting these days. In the case of sole proprietary businesses, cash basis of accounting is seen in practice. Where the sole proprietary businesses are well established, they also practise accrual basis of accounting.

Note: *Inherent in the accrual basis of accounting, is the matching principle, which states that expenses should be deducted against revenue to which they are directly related.*

1.4 Book-keeping versus accounting

Book-keeping is the systematic recording of a company's financial transactions. It also includes the maintenance of correct and up-to date financial records of a company. The process is up to drawing of trial balance. There are two methods of recording the financial transactions:

❍ **Single entry**
It is also known as incomplete recording of transactions. Every transaction is recorded with its single aspect. Preparing complete set of financial statements is difficult from single entry record books. It is old system of book-keeping.

❍ **Double entry**
It is about complete recording of transactions with its dual aspect. Every transaction has a debit and credit aspect which is recorded in two accounts separately. It is perfect system of book-keeping and is used all over the world. Complete set of financial statements can be prepared from the double entry records easily.

"Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least of financial character and interpreting the results thereof." (**AICPA**)

Book-keeping is the part of accounting. Where the work of a book-keeper finishes, the work of an accountant starts. Accountants often review the work of the book-keepers. The spectrum of accounting activity is much broader than book-keeping.

1.5 Introduction to an account

An account represents a document used to record all similar transactions. It consists of a title, a debit column, and a credit column. The left side of an account is called as debit side, and the right side of the account is known as credit side. The balance of an account is determined by subtracting the smaller sum (debit or credit) from the larger sum. Initially, all transactions are recorded in a journal or day-book in a process known as journalizing. When the information recorded in the journal is transferred to the individual accounts, this process is known as posting. Total debits and credits of any transaction must always be equal.

A single account is often called a **T-Account** because of its appearance similar to an alphabet **T**. When several related accounts grouped together in a register or book format, they are called a ledger. Accounts whose balance is carried forward from period to period are known as real accounts or balance sheet accounts. In a double entry accounting system, all journal entries require a debit entry in one account to be simultaneously matched by an equal credit entry in another account. A journal entry composed of more than one debit or credit is a **compound journal entry**.

1.6 Rules for increasing & decreasing accounts

The following are rules for increasing and decreasing accounts:

- Asset accounts normally have debit balances and are increased by debits.
- Liability accounts normally have credit balances and are increased by credits.
- Owner's equity accounts normally have credit balances and are increased by credits.
- Revenue accounts are increased when credited.
- Expense accounts are increased when debited.

1.7 Accounting equation

The accounting equation is the basis of double entry book-keeping of today. The accounting equation has told us that balance sheet must always balance. It is given as follows:

Assets = Owners' Equity + Liabilities

1.8 Types of accounting entries

The following are the types of accounting entries that are passed in books of accounts at different times of the accounting cycle:

- **Recording entries**: These entries are passed when any transaction takes place.
- **Correcting entries**: These entries are passed when incorrect entries are rectified.
- **Adjusting entries**: Normally at year end, many entries are passed to adjust balance sheet accounts.
- **Reversing entries**: These entries are passed at year end for some deferred and accrued accounts.
- **Closing entries**: These entries are passed at year end to closing all profit & loss accounts.

1.9 Normal account balances

Assets, drawing, dividends, and expense accounts normally have debit balances. Liabilities, owner's equity, retained earnings, and revenue accounts normally have credit balances. There can be special circumstances where accounts will not have a normal balance, but this usually is an indication of an error or extraordinary or unusual transactions**.**

1.10 Income statement accounts

Income statement accounts or nominal accounts have a direct effect on the balance of owner's equity. Expense accounts decrease owner's equity, while revenue accounts increase owner's equity. The net gain or loss is determined by subtracting expenses from revenues. At the end of a financial period, all expense and revenue accounts are closed to a summarizing account usually called Income Summary. For this reason, all income statement accounts are considered to be temporary or nominal.

1.11 Balance sheet accounts

Balance sheet accounts or permanent accounts are classified as assets, liabilities, or owner's equity. Income statement accounts are classified as either expenses or revenues. Assets are divided into two categories, depending upon their expected life. Current assets are those that are usually sold or consumed within a year. Fixed assets are held for periods longer than a year. Among fixed assets, all assets except land depreciate. Liabilities are also divided into two categories: current, for those payable within a year, and long-term, for those with maturities exceed one year.

Current assets typically include cash, notes receivable, accounts receivable, inventories and prepaid expenses (such as insurance premiums). Fixed assets typically include property, plant and equipment, vehicles, investments, patents, franchises and trademarks.

Both tangible and intangible items can be assets, provided they have some monetary value. Current liabilities include bank credit outstanding, accounts payable, interest payable, wages payable and taxes payable. Long term liabilities include loans beyond one year, notes and bonds issued by company.

1.12 Classifying balance sheet accounts

Owner's equity is the portion that remains after liabilities are subtracted from assets. For a sole proprietorship or partnership, capital represents the owner's equity. For a company, capital stock is the investment made by stockholders. Retained earnings represent net income that a company retains. Dividends are earnings of a company that are distributed to shareholders. Drawings represent assets taken out by owners of proprietorships or partnerships. Drawings and dividends reduce owner's equity**.**

1.13 Classifying income statement accounts

Revenues increase the value of owner's equity. Revenues include sales, fees earned, services, interest income and rental income. For businesses with more than one source of income, it is recommended to maintain separate accounts. Expenses vary for different businesses, and they should be classified according to the size and type of expense.

1.14 Chart of accounts

All accounts of a business should be listed in a chart of accounts. Usually the accounts are classified as:

- **Assets,** (for example Asset Account number may start from 1000 to 5000)
- **Liabilities,** (Account number from 5001 to 10000)
- **Owner's equity,** (Account number from 10001 to 15000)
- **Revenue,** (Account number from 15001 to 20000) **and**
- **Expenses,** (Account number from 20001 to 25000).

Accounts appear in the **General Ledger in** a sequential order of the chart of accounts. The first digit of a number in the chart of accounts indicates the major division in which the account is placed. A second number of an account represents a specific category. When the **General Ledger** is first prepared and account balances from the previous period are entered, this is known as opening the ledger.

1.15 The flow of data

- The accounting data normally follows a normal pattern of flow. Its order is:
  The actual business transaction requires the preparation of documentation,
- The entry for the transaction is recorded in the Journal or Day-Book, and
- The journal entry is posted to General Ledger.

1.16 The two column journal

Of all types of journals, the two column journal is the simplest to use. It has a debit column and a credit column used for recording all initial transactions. Before a transaction is entered into a journal, it is necessary to determine the following:

- Which accounts will be affected,
- Whether the affected account increases or decreases, and
- Whether the transaction should be recorded as a debit or credit.
- An explanation of the transaction is desirable.

When journalizing entries it is customary to enter the account numbers and exact name of the accounts to be debited and credited, to write in the debit portion first above the credit portion, and to indent slightly the credit entry. The complete date of a transaction must always appear. Most often expense account will have only debit entries; revenue accounts only credit entries, while balance sheet accounts may have either.

1.17 Three-column & four-column accounts

Three-column and four-column accounts are often used instead of two-column accounts. The purpose of the additional columns is to keep running balances of both debits and credits in the four-column account, or a net of the two in the three-column account. All accounts, as well as most accounting forms used to record transactions, often have a posting reference column. In the journal, the posting reference column is used to record the account number or code. In the individual account, the posting reference (also called journal reference) is used to record the page number of the journal where the entry was made.

Three-column and four-column accounts must show their account number and name, year and month, at the top of each page. Three-column and four-column accounts are most conveniently used in computer based accounting since debit and credit balances are automatically calculated.

1.18 The trial balance & errors

The trial balance is a list of accounts with their debit or credit balances. It is usually prepared at the end of an accounting period. The advantages of using a trial balance are:

- It reveals mathematical errors since total debits must equal total credits, and
- It assists in the preparation of financial statements. It should be noted, however, that trial balances cannot detect every type of error.

The first step in preparing a trial balance is to calculate the balance of each of the accounts in the General Ledger. Some of the errors that the trial balance will not reveal are for instance:

- Journalizing a transaction twice,
- Forgetting to record a transaction,
- Entering an erroneous but identical amount in debit and credit,
- Posting part of a transaction as a debit or credit to the wrong account

Errors that cause the trial balance not to balance are:

- The beginning amount of an account was incorrectly recorded,
- A debit entry was posted as a credit entry,
- A debit or credit balance was omitted,
- A digit in a number was moved one or more spaces (known as **slide**).

Determining the amount of the difference between debit and credit can help to look for such amount. For instance, when a debit and a credit were interchanged, the trial balance difference will be twice this amount.

A major function of an auditor is to find accounting errors.

1.19 Matching revenues & expenses

There are two methods of recording revenues and expenses in the income statement:

- Accrual basis and
- Cash basis.

The accrual basis of accounting is the correct method of matching revenues and expenses, and it is widely used. It matches revenues and expenses when they are incurred rather than when cash is received or disbursed. The cash basis of accounting records revenues and expenses only when cash is received or disbursed, and this method is often not acceptable for many forms of business. The cash basis of accounting does not match revenue with the expenses, whereas accrual basis of accounting matches revenues with expenses therefore reflects correct profitability of business for the given period of time.

1.20 The adjustment process

At the end of a financial period, many balances listed in the trial balance are required of some adjustment. Common adjustments pertain to prepaid expenses, fixed assets, and accrued expenses. If the proper adjusting entries are not made, financial statements will be incorrect. It is not necessary to keep track of transactions that affect revenues and expenses on a day to day basis. Adjustments should be made at the end of each accounting period.

1.21 Prepaid expenses - adjustments

At the end of an accounting period, adjustments must be made to reflect the portion of the asset that has been consumed during the period. The amount of asset or prepaid expense consumed is recorded as a debit to the expense account, and a credit to the asset account. Should an adjusting entry not be made, expenses, net income, owner's equity and assets would all be overstated**.**

1.22 Non-current assets - adjustments

Non-current assets comprise of tangible and intangible assets owned by a company. Although it is often not visible, the usefulness of non-current assets declines over the period of use. This loss of usefulness is known as depreciation or amortization, and it requires an adjusting entry periodically. The decline in value requires a debit to depreciation or amortization expense account, and a credit to accumulated depreciation or amortization (which is said to be a contra asset account). The difference between the balances of the asset and contra asset accounts is the book value of the asset. If the adjusting entry is not made, assets, owner's equity, and net income will be overstated, and expenses will be understated.

1.23 Liabilities - adjustments

While most expenses are prepaid, a few are paid after a service has been performed. This is the case of wages and salaries. Since the expense has not been paid but services have been received, an accrued expense and a liability have taken place. The adjusting entry requires a debit to an expense account and a credit to a liability account. Failure to do so will result in net income and owner's equity being overstated, and expenses and liabilities being understated.

1.24 Work sheets & financial statements

The work sheet is a collection of important data that is used to determine which adjusting entries must be performed. It also assists in the preparation of financial statements. The first step of preparing a work sheet is the trial balance. Once a trial balance is balanced (i.e. total debits equal total credits), adjusting entries can be performed. To make certain all debits and credits still prove after all adjusting entries, an adjusted trial balance is created. Once the adjusted trial balance proves, if is separated into an income statement and a balance sheet. All columns of the work sheet should have equal balances for debits and credits.

1.25 Preparing financial statements

The work sheet is used in the preparation of the financial statements. The results of the income statement (net profit or loss) are transferred to the statement of owner's equity. If additional funds have been invested or withdrawn over the period, such changes are recorded to the statement of owner's equity. The owner's equity account in the balance sheet is transferred from the statement of owner's equity. All other balances of the balance sheet are transferred from the work sheet balance sheet columns.

1.26 Journalizing & posting closing entries

After the financial statements are completed, all adjusting entries are recorded in the journal and posted to the ledger so that all financial statements are in agreement. It is necessary to close all temporary accounts and record the net change to the owner's equity account. This is accomplished by journalizing and posting closing entries for all temporary accounts. An Income Summary account is used to summarize revenue and expense accounts, and establishing the net profit or loss for the period. In addition, any transaction that increases or decreases capital should also be posted to the appropriate capital account.

PROCEDURES TO CLOSE TEMPORARY ACCOUNTS

- **Debit all revenue accounts, and credit Income Summary.**
- **Credit all expense accounts, and debit Income Summary.**
- **Add debit and credit columns of Income Summary. If the credit balance exceeds the debit balance, a profit has been realized.**
- **Results of the Income Summary should be posted to a capital account (Owner's or Shareholders equity).**
- **If there is activity in the Drawing or Dividend accounts, it is necessary to credit those accounts and debit a capital account.**

1.27 The accounting cycle

The accounting cycle begins with the analysis of all transactions and recording them in the journal. Once all transactions have been recorded in the journal, they are posted to the ledger and a trial balance is drawn. The trial balance, adjusting entries, and any additional information for the financial statements are recorded in the work sheet. After the completion of the work sheet, the financial statements are finalized. All adjusting and closing entries are then journalized and posted to the ledger. To ensure all entries were correctly made, a post-closing trial balance is prepared to show the equality of debits and credits, as well to confirm Assets, Liabilities, and Capital accounts with proper open balance. The accounting cycle finishes with the passing of reversing entries wherever needed.

1.28 The final product of book-keeping & accounting

The following statements are the final product of book-keeping and accounting cycle.

- Statement of financial position.
- Statement of comprehensive income or statement of earnings.
- Statement of cash flows.
- Statement of changes in stock-holders' or owners' equity.

IMPORTANT NOTE

IFRSs have used the following terms for the old terms:

#	Old term	New adoption
1	**Balance Sheet**	**Statement of financial position**
2	**Profit & Loss Account**	**Statement of earnings**
3	**Cash Flow Statement**	**Statement of cash flows**
4	**Retained Earnings Statement**	**Statement of changes in owners' equity**

UNIT 2: ACCRUALS & DEFERRALS

2.1 Introduction

Deferrals and accruals are instrumental in properly matching revenues and expenses. A deferral delays the recognition of either an expense that has been paid or revenue that has been collected. An accrual is an expense that has not been paid or revenue that has not yet been received.

2.2 Deferrals - prepaid expenses

Prepaid expenses represent the cost of goods and services purchased that are not entirely used up at the end of the year. Adjusting entries are necessary so that asset and expense accounts have the proper balances. Prepaid expenses can be initially recorded as either an asset or an expense. Either method will yield the same results, but adjusting entries to obtain the final result differ. The advantage of recording a prepaid expense initially as an asset is that no reversing entry is necessary.

- **When a prepaid expense (rent, insurance, etc., etc.) is recorded as asset, following set of entries is passed:**

Date	Description	Ref.	Dr.	Cr.
			AED.	AED.
01/01/11	Prepaid rent expense		xxx	
	Cash			xxx
	(Being Cash Paid as prepaid expense.)			
31/12/11	Rent expense		xxx	
	Prepaid rent expense			xxx
	(Being adjustment of prepaid rent passed for the amount of expense for the year 2011)			

N.B.:
- There is no need to pass reversing entry in this case.
- Closing entry is the same that is passed for all expenses.

❍ **When a prepaid expense is recorded as expense initially, following set of entries is passed:**

Date	Description	Ref.	Dr.	Cr.
			AED.	AED.
01/01/11	Rent expense		xxx	
	Cash			xxx
	(Being Cash Paid as prepaid expense.)			
31/12/11	Prepaid expense		xxx	
	Rent expense			xxx
	(Being adjustment of prepaid rent passed for the amount of unutilized or remaining balance of prepaid expense after the expense for the year 2011)			
01/01/12	Rent expense		xxx	
	Prepaid rent			xxx
	(Reversing entry of adjusting entry passed on 31/12/11.)			
N.B.: Closing entry is the same as passed in above illustration.				

2.3 Deferrals - unearned revenues

When revenue is received before goods are delivered or services performed, the revenue is said to be unearned. Unearned revenues can initially be recorded as either a liability or revenue. When unearned revenues are recorded as liabilities, an unearned revenue account is credited. An advantage of this method is that no reversing entry is necessary. When unearned income is recorded as revenue, a revenue account is credited. This method requires a reversing entry at the beginning of the new period. Both methods produce, however, the same end result.

- **When advance receipt of revenue is recorded as unearned revenue, following set of entries shall be passed**:

Date	Description	Ref.	Dr.	Cr.
			AED.	AED.
01/01/11	Cash		xxx	
	Unearned revenue			xxx
	(Being Cash received for revenue not earned.)			
31/12/11	Unearned revenue		xxx	
	Revenue earned			xxx
	(Being adjustment of advance receipt of revenue passed for the amount of revenue earned for the year 2011)			

N.B.:

- There is no need to pass reversing entry in this case.
- Closing entry is the same that is passed for revenue.

- **When advance receipt of revenue is booked as revenue earned, following set of entries is passed:**

Date	Description	Ref.	Dr.	Cr.
			AED.	AED.
01/01/11	Cash		xxx	
	Revenue			xxx
	(Being cash received for revenue not earned.)			
31/12/11	Revenue		xxx	
	Unearned revenue			xxx
	(Being adjustment of advance receipt of revenue passed for the amount of revenue unearned on 31/12/11)			
01/01/12	Unearned revenue		xxx	
	Revenue			xxx
	(Being reversing entry of adjusting entry passed on 31/12/11)			

N.B.:

- Closing entry is the same that is passed for revenue.

2.4 Accruals - liabilities or expenses

Many expenses which accumulate on a daily basis are only recorded at set intervals. At the end of an accounting period a portion of such expenses (for instance, salaries) often remains unpaid. Such accruals are considered to be both liabilities and expenses. An adjusting entry is necessary at the end of an accounting period to properly reflect the portion of the accrued but yet unpaid expense and liability. At the start of the next period, the adjusting entry is reversed to simplify accounting.

Date	Description	Ref.	Dr.	Cr.
			AED.	AED.
31/12/11	Salaries expense		xxx	
	Accrued salaries expense			xxx
	(Being salaries accrued on the closing of the year 31/12/11.)			
01/01/12	Accrued salaried		xxx	
	Salaries expense			xxx
	(Being reversing entry of the adjusting entry passed on 31/12/11.)			

2.5 Accruals - assets or revenues

Many businesses only record revenues when they are actually received. At the end of an accounting period, all revenues earned but not yet collected require adjusting entries. The adjustment is performed by debiting an asset account and crediting a revenue account. As a result, financial statements will be able to properly match revenues and expenses. A reversing entry is performed at the first day of the new period to simplify accounting.

Date	Description	Ref.	Dr.	Cr.
			AED.	AED.
31/12/11	Accrued Revenue		xxx	
	Revenue			xxx
	(Being the amount of revenue earned but not collected on 31/12/11)			
01/01/12	Revenue		xxx	
	Accrued Revenue			xxx
	(Being the reversing entry of the adjusting entry passed on 31/12/11.)			

2.6 Reviewing accruals & deferrals

Although all accruals and deferrals require adjusting entries at the end of an accounting period, reversing entries are not necessary for all adjustments. Reversing entries should only be performed under the following circumstances:

- When an accrued asset or an accrued liability is adjusted,
- When a prepaid expense is initially recorded as an expense, and
- When unearned revenue is initially recorded as revenue.

UNIT 3: ACCOUNTING SYSTEMS

3.1 Principles of accounting systems

The accounting system of an organization should provide all necessary information. The type of accounting system used depends on the information needs of an organization. All accounting systems should have the following characteristics:

- Cost effectiveness,
- Adequate internal controls,
- Flexibility to a changing environment and
- Compatibility and adaptability to an organization's structure.

Accounting system is an organized set of manual and computerized accounting methods, procedures and controls established together to record, classify, analyze, summarize, interpret and present accurate and timely data for managerial decisions.

The accounting system can be manual or mechanical. In the past, the accounting systems were maintained manually. Even today, many small businesses use manual accounting systems. Manual accounting systems have many limitations for accuracy and reporting. Therefore, companies use computerized accounting systems. They provide fast and accurate reporting of the company’s earnings and financial health at any time. Some of the famous accounting system providers are:

- SAP
- Oracle
- Microsoft

3.2 Installing & revising accounting systems

The installation and revision of an accounting system requires a complete knowledge of business operations. The following steps are necessary when installing or changing an accounting system.

- **Systems analysis**

  This stage determines data needs, the sources of data and any problem in processing current data.

- **Systems design**

  This stage involves designing new or revising current accounting systems based upon the results of the system’s analysis.

- **Systems implementation**

  This final stage installs and evaluates the new or revised accounting system.

3.3 Internal controls

Internal controls are designed to safeguard assets, check accuracy of accounting data, promote efficiency, and encourage adherence to company policies. Internal accounting controls are specifically concerned with the protection of assets and the reliability of accounting information. Internal administrative controls are concerned with operational efficiency, and help determine whether business goals are being met.

3.4 General Ledger

A General Ledger is a complete record of financial transactions over the entire life of a company. The ledger holds account information that is needed to prepare financial statements. Trial balance is drawn from the closing balances of accounts given in a General Ledger.

A General Ledger has the following set of accounts:

- Assets
- Liabilities
- Revenue
- Expenses
- Gains
- Losses
- Owner's equity

3.5 Subsidiary Ledgers

Subsidiary Ledgers are used for accounts that have a large number of individual accounts with common characteristics. Every Subsidiary Ledger has a controlling account which can be found in the General Ledger. The sum of the balances of the Subsidiary Ledger must be equal to the controlling account. Some commonly used Subsidiary Ledgers are for the following heads of accounts:

- Accounts receivable,
- Accounts payable or creditors' account,
- Inventory,
- Fixed assets,
- Projects,
- Work-in-progress and
- Cash Book.

3.6 Cash Book

Cash book provides complete details of cash receipts and payments over the entire life of a business. Sufficient description should be entered against each receipt and payment to disclose fully the nature of the transaction and the relevant voucher referred to by its number.

Additional columns can be inserted on both sides of the Cash Book in the case where a company is using a Current Bank Account for receipts and payments of transactions.

3.7 Difference between General Ledger & Subsidiary Ledger

The difference between Subsidiary and General Ledger accounts is functional. A company's General Ledger is the book of top-tier accounts that make up its accounting system. The Subsidiary Ledger is a sub-account of a General Ledger account. General Ledgers record line item transactions in major account categories. Subsidiary Ledgers provide the details for one of those line items, creating a separate mini account for the item that can track transactions that are specific to that one item. For example, trade debtors' account in a General Ledger has a balance of 100 customers over a given period of time whereas a Subsidiary Ledger has the detailed accounts of 100 customers. A reconciliation of the General Ledger Balance with Subsidiary Ledger Balances is recommended where manual accounting systems are in place.

3.8 Special Journals

Special journals (or day books) are designed to record a specific type of transaction which occurs frequently. The following is a summary of the four most commonly used special journals:

- **Purchases Journal**: used to record purchases on credit,
- **Sales Journal**: used to record all sales made on credit,
- **Cash Payments Journal**: records all cash disbursements, and
- **Cash Receipts Journal**: records all cash receipts.

In certain instances, business documents such as purchases and sales invoices are used instead of special journals to reduce expenses.

3.9 Purchases Journal

Items commonly purchased on account are goods held in inventory for sale, supplies, and equipment. The accounts payable account is always credited, and an asset account is debited. Assets purchased on a recurring basis have their own column in the journal. Assets purchased less regularly are posted in the sundry accounts section of the journal. At all times, total debits must equal total credits. At the end of an accounting period, all entries should be posted to a Subsidiary Ledger or a General Ledger.

3.10 Cash Payments Journal

When the Cash Payments Journal is used, the cash column is always credited whenever a payment is issued. When a payment is made for goods previously purchased on credit, the accounts payable column is credited. In the event a discount is offered for early payment, the purchases discounts column should be debited. The sundry accounts column is used for debits to accounts which do not have an individual column. At the end of the month, all data from the journal should be posted to Subsidiary Ledgers or the General Ledger. The sum of the accounts payable Subsidiary Ledger must be equal to the controlling account. In the event it is not, errors must be found and corrected.

3.11 Sales Journal

The Sales Journal is only used to record sales of merchandise on account. A unique feature of the Sales Journal is that accounts receivable debits and credits share the same column. A column also often exists to record sales tax payable. Any sales returns or allowances granted for goods sold on credit require an entry to the general journal. If a cash refund is given, the transaction should be recorded to the Cash Payments Journal.

3.12 Cash Receipts Journal

The Cash Receipts Journal is used to record all transactions that increase the cash balance. The most common sources of cash receipts are cash sales and payments for goods on account. When debtors pay for goods purchased on account, the accounts receivable column should be credited. If a cash discount is taken by a customer, the sales discount column should be debited for the cash discount. All accounts in the Cash Receipts Journal are posted periodically to the General Ledger. Accounts receivables should be posted monthly to the accounts receivable Subsidiary Ledger.

3.13 The voucher system

One of the most common methods to control transactions is the voucher system. The components of a voucher system are:

- Vouchers: documents proof of a transaction,
- A voucher register: to record every voucher,
- An unpaid voucher file,
- A paid voucher file, and the
- A check register: to record the payment of each voucher.

The voucher system provides effective accounting controls and helps management in effective internal control process.

3.14 Types of vouchers

Following are the types of vouchers that are used in every business:

- Cash Receipt Voucher **(CRV)**
- Cash Payment Voucher **(CPV)**
- Bank Receipt Voucher **(BRV)**
- Bank Payment Voucher **(BPV)**
- Journal Voucher **(JV)** is prepared for all non-cash transactions.

Important note

These are the minimum number of vouchers that are required in an accounting system. If we examine the computerized accounting systems, they have opened a large number of vouchers depending upon the company needs. For instance, there can be many vouchers that are automatically generated by the system to adjust various accounts at the close of the year and they fall under different names but they have common nature to that of a Journal Voucher **(JV).** A computerized system may use any number of vouchers but if we see the nature of all vouchers they are falling the five main categories mentioned above.

3.15 Petty Cash Voucher

This voucher is used for internal transactions pertaining to small expenses paid out from petty cash fund. To account for petty cash transactions, a triplicate **Petty Cash Voucher** (also known as **Cashier's Voucher**) is prepared every time funds are withdrawn from petty cash. The pink copy of the voucher is given to the individual receiving the cash. The yellow copy is retained by the petty cash custodian and is subsequently submitted to Accounting Department with **Expense Claim Form** when the expenditure is documented and the fund is to be replenished. The white copy (original) is retained with the petty cash fund. At any time, the total of cash and outstanding petty cash vouchers (white copies) should equal the total amount of the fund as originally established.

3.16 Important facts about vouchers

- Printed vouchers must be used.
- All vouchers must be pre-numbered.
- All vouchers must be properly completed for all particulars.
- All vouchers must be signed by all concerned officials.
- All vouchers must be supported with all documentary evidences of each transaction. Voucher is the proof of the transaction. This is why; a separate voucher is prepared for each transaction. This is highly incorrect practice to prepare one voucher for a number of transactions.
- All vouchers must be filed properly.
- Cancelled vouchers must have a separate record for their verification by the auditors.

- An example for signing a Cash or Bank Payment Voucher, following procedures must be completed. Check that the receiving report, invoice and purchase order is attached with it. Perform necessary calculations for possible discounts availed on the purchase transaction.

3.17 Important facts about Voucher Register

- All vouchers must be recorded in the voucher register.
- Vouchers are listed in numerical order.
- The register records the payee, the date the payment is made and the number of the check issued for payment,
- The Accounts Payable account is always credited, but there may be different accounts to be debited.
- The Sundry Accounts is used to debit accounts not listed in the other Register columns.

3.18 Voucher files procedures

- Unpaid vouchers are filed in the unpaid voucher file.
- Unpaid vouchers should be filed in the order they are due.
- Paid vouchers are filed in the paid voucher file.
- Paid vouchers are filed in numerical order.
- On the due date a voucher is removed from the "unpaid" voucher file and forwarded to the firm's disbursing officer for final approval of payment.

3.19 Advantages of a voucher system

- Trail of documents can be checked easily.
- Documentation defect can be traced.
- Provides control on record maintenance and use.
- Provides bases for accounting entries.
- Best from auditing point of view because all documents are maintained in a systematic manner. It provides quick access to all documents for an accounting entry.
- A voucher provides the easiest way for filing invoices and supporting documents for future reference.
- Unpaid vouchers are filed by their payment dates to help in making prompt payment.
- An unpaid vouchers file and a paid vouchers file eliminate incorrect posting to an accounts payable ledger.
- A paid vouchers file provides three different and easy ways to find information about a paid voucher:
  - If know voucher #, look in the voucher register
  - If know check #, look in the check register
  - If know the payee name, look in the paid vouchers file under

3.20 Using a Check Register

- When a voucher is paid, it is recorded in the check register.
- The check register is similar to the Cash Payments Journal.
- All checks should be listed numerically, even those that are voided.
- Cash in Bank account should always be credited. If a discount is taken, credit the Purchases Discount account.
- Voucher numbers and a running cash balance column are used in the check register.

3.21 The year- end of a company

Every company is supposed to close the books of accounts at its year end. The year-end may or may not be a calendar year. It depends upon the choice of the management or the cycle of the business to choose a year end. For example, in textile industry, the year-end is according to the cotton crop seasons. And in Banking Industry the year end is different from textile industry based on the banking traditions profession-wide. At each year-end, record books are closed to evaluate the following:

- Profitability of the business for the year
- Financial health of the business at the end of the year (↑ increase or ↓ decrease in assets and liabilities accounts)
- Cash flow position during the year for the year (separate for each set of operating, investing and financing activities of the business during the year.)
- Increase or decrease in the wealth of the owners of the business for the year.

UNIT 4: CASH & BANK

4.1 Bank accounts

The most effective tool used to control cash is a bank account. It provides a double record of all cash transactions. In order to provide effective controls on the use of bank accounts, special documents are used to evidence transactions. Signature cards are used by all employees authorized to make withdrawals. Deposit slips must accompany deposits, and checks must be issued for all payments. A remittance advice is sent with each payment to ensure that proper credit is recorded by creditors.

4.2 Bank statements

An advantage of using a bank account to control cash is that banks show a bank statement online that reflects all the transactions in the account on real time basis. Information normally present in the bank statement consists of the beginning and ending balances, deposits, other credits, withdrawals and other debits. The cancelled checks are enclosed with the statement, as well as debit and credit memorandums (for items processed by the bank usually unknown to the depositor). Rarely will the bank statement balance and the depositor's Cash in Bank account balance be exactly the same, and they must be reconciled.

4.3 Bank reconciliations

Bank reconciliation is a method used to determine the reasons for discrepancies between the bank statement balance and the Cash in Bank account balance and to calculate an adjusted balance. Discrepancies are usually due to outstanding items which have not yet been recorded by either of the bank or the company, and which typically include checks not yet presented for collection, deposits in transit and bank service charges. Errors are another common cause of discrepancies, which the reconciliation will help correct. Finally, the reconciliation may uncover irregularities.

4.4 Bank reconciliations statements

Bank reconciliation is divided into two sections, the balance per bank statement and the balance per depositor's records. Although it is possible to reconcile one balance to the other, common practice adjusts both balances to prove to one another. Outstanding transactions unknown to the depositor discovered when the bank statement was sent require journal entries.

Since bank statements are available online, therefore, bank reconciliation statements can be prepared on daily basis. It provides real time controls on discrepancies in bank statements and bank accounts. In companies where bank transactions are in thousands in number in a day or greater than this, there are chances of very big discrepancies in accounts. To avoid the risk of unrecorded transactions, the accountants must prepare bank reconciliation statement of all bank accounts on daily basis before the close of every day.

XYZ LLC
Bank Reconciliation Statement
For the Month of December 31, 2009

Description	Amount in AED.
Balances as per Bank Statement	XXX
Reconciling Items:	
Less: Company Credits not debited by ban	xxx
Plus: Company Debits not credited by bank	xxx
= **Balance as per company book**	XXX

4.5 Cash accounts

There are often several cash accounts because they serve different purposes. The Cash in Bank account represents the checking account that processes deposits, checks and memorandum items. The Cash Short and Over account is used to record any variance by sales clerks. The Cash-on-hand fund is used to provide change to conduct business with customers. The Petty Cash Fund is used to pay for small items with cash. Each of these cash accounts needs to be strictly controlled to prevent mishandling.

4.6 Internal controls for cash accounts

Numerous procedures are available to control cash accounts. Monthly bank statements help verify the cash account balance. The bank reconciliation is particularly useful in controlling cash receipts. The voucher system is used to control cash payments. Different cash funds exist for specific purposes to keep track of each type of cash transaction. It should be noted that it is of utmost importance to separate cash handling and cash related accounting duties.

4.7 Electronic Funds Transfer

The use of electronic funds transfer (EFT) is the fastest way for the processing of cash transactions. EFT uses electronic impulses that are computerized to perform cash transactions. This eliminates the need for checks and physical money transfers. EFT has a particularly strong presence in retail sales. Point-of-sale systems are used by customers to pay for purchases using credit cards, charge cards, and bank cards. The greatest benefit EFT can provide is reduced costs, and quicker and more accurate information.

UNIT 5: RECEIVABLES

5.1 Introduction

Receivables are monetary claims against trade debtors for sales made on credit to customers. Credit can be granted in two forms: open account or evidenced by a formal instrument. When a formal instrument of credit that is a promissory note, the creditor has a stronger legal claim and can endorse it to a third party. The party that promises payment is known as the maker, and the party entitled to receive the payment is the payee. Notes receivable can be interest or non-interest bearing. The amount due at maturity, known as maturity value, is equal to the face value plus any accrued interest. Receivables not expected to be collected within the current year, should be listed as investments on the balance sheet.

5.2 Receivable controls

Receivables require the same internal controls as other assets of a business. Employees responsible for collecting and approving receivables should not be involved with accounting aspect related to them. All accounting functions should be designed so that the work of one employee can be used as verification of another employee's work. A business that has a substantial amount of notes may find the use of a notes receivable register very helpful. It provides detailed information on each note, and assists in the timely collection of notes. Proper controls of receivables also include obtaining approval for credit sales, sales returns and allowances, and sales discounts.

5.3 Calculating interest

Interest rates are usually stated on an annual basis. The interest is computed by multiplying principal by rate and then by time (principal x rate x time). The maturity value is determined by calculating interest and adding it to the face value of the note. When interest is computed for periods of less than a year, time is expressed as a fraction. The numerator of the fraction is the length of the note and the denominator is the number of days in a year. Government agencies use 365 days in the denominator, while the private sector uses 360 days.

5.4 Accounting for notes receivable

When a note is received from the debtor (i.e. open account customer), a journal entry should be made debiting Notes Receivable and crediting Accounts Receivable account. Notes receivable that do not mature by the end of a fiscal period, require both adjusting and reversing entries for the accrued interest. This is done so that interest income is allocated to the proper financial periods. When a note matures and is paid, the Cash account is debited and the Notes Receivable and Interest Income accounts are credited.

5.5 Discounting a note receivable

In the event a business is in need of cash, it has the option to transfer its notes receivable to a bank, which is known as discounting. The interest a bank charges on the period it holds a note is known as discount. Depending upon the arrangement with the bank, the company may still be liable in the event a debtor defaults on the payment. It is necessary to disclose these contingent obligations on a firm's Balance Sheet in a foot note. When proceeds are received for the discounted notes, the Cash account is debited, and the Notes Receivable account credited. If the proceeds exceed the face value of the note, the Interest Income account is credited. If the proceeds are less than the face value of the note, Interest Expense is debited.

5.6 Dishonored notes receivable

When the maker of a note fails to pay on the due date, the note receivable is considered to be dishonored. A dishonored note is no longer negotiable. In the books of creditors, the following entry is made:

Description	Ref.	Dr.	Cr.
		AED.	AED.
Accounts Receivable		xxx	
Interest receivable			
Notes Receivable			xxx
Interest Income			xxx

When a note previously discounted with a bank is dishonored, the holder of the note (the bank) notifies the endorser (i.e. the company) of non-payment. Protest fees are charged to the endorser as legal fees.

5.7 Receivable balances which become uncollectible

No matter what kind of credit policy or collection procedures a business establishes, a certain percentage of receivables will usually turn out to be uncollectible. When a receivable is determined to be uncollectible, it is written-off as an operating expense. Strong indications that a receivable may be uncollectible are the declaration of bankruptcy by the debtor, repeated failures to collect, disappearance of the debtor and debts that are beyond the statute of limitations. Two methods exist to write-off receivables. The direct write-off method records the expense when the receivable is uncollectible, while the allowance method makes a provision for a portion of the current year sales to become uncollectible throughout the entire year.

5.8 Methods used to estimate un-collectible balances

There are several methods of estimating uncollectible. The most commonly used methods base their estimates on sales data or the age of the receivables. Estimates based on sales figures can be determined by taking a percentage of either total sales or credit sales. An estimate of uncollectible based on an analysis of receivables, classifies accounts into outstanding age groups. The longer a receivable is past due, the higher the probability of nonpayment. If the estimate is larger than the balance of the Allowance for Doubtful Accounts, the excess should be debited to the Uncollectible Accounts Expense and credited to Allowance for Doubtful Accounts.

5.9 The allowance method

The allowance method of accounting for uncollectible estimates the percentage of accounts that will be uncollectible. Once the amount is determined, an adjusting entry is made that debits Uncollectible Accounts Expense and credits Allowance for Doubtful Accounts (also known as Allowance for Bad Debt). When a specific account is determined to be uncollectible, Allowance for Doubtful Accounts is debited and Accounts Receivable Account is credited. The advantage of using the allowance method is it provides a reduction of the value of receivables and recognition of expense in the period the corresponding sales have taken place.

5.10 The direct write-off method

The direct write-off method only records an uncollectible account expense when an account has been determined to be uncollectible. This method is not recommended because the recognition of the expense does always occur in the year the corresponding revenues were recorded. It has, however, the advantage of simplicity since no adjusting entry is necessary at the end of a financial period. The method is best used by businesses that do not have a large number of credit sales. In the event an account needs to be reinstated, the Accounts Receivable account is debited. Uncollectible Accounts Expense should be credited.

UNIT 6: INVENTORIES

6.1 Introduction

Inventories are usually the largest current asset of a business and proper measurement of them is necessary to assure accurate financial statements. If inventory is not properly measured, expenses and revenues cannot be properly matched. When ending inventory is incorrect, the following balances of the balance sheet will also be incorrect as a result: merchandise inventory, total assets, and owner's equity. When ending inventory is incorrect, the cost of merchandise sold and net income will also be incorrect on the income statement.

6.2 Inventory accounting systems

The two most widely used inventory accounting systems are the periodic and the perpetual. The perpetual inventory system requires accounting records to show the amount of inventory on hand at all times. It maintains a separate account in the Subsidiary Ledger for each good in stock, and the account is updated each time a quantity is added or taken out. In the periodic inventory system, sales are recorded as they occur but the inventory is not updated. A physical inventory must be taken at the end of the year to determine the cost of goods sold. Regardless of what inventory accounting system is used, it is good practice to perform a physical inventory at least once a year.

6.3 Determining inventory quantities & costs

All goods owned by a business (whether or not physically present on the business premises), are included in inventory when an inventory is taken. This requires that all shipping documents be examined, and all merchandise out on consignment be identified. Determining the quantity of goods on hand should be performed by at least two individuals, and a third should verify accuracy of the count (especially if the goods have a high monetary value). When determining the cost of goods, all expenses incurred to acquire them are included in the purchase price.

6.4 Inventory costing methods - periodic

The periodic system records only revenue each time a sale is made. In order to determine the cost of goods sold, a physical inventory must be taken. The most commonly used inventory costing methods under a periodic system are:

- First-in first-out (**FIFO**),
- Last-in first-out (**LIFO**), and
- Average cost or weighted average cost.

These methods produce different results because their flow of costs is based upon different assumptions. The **FIFO** method bases its cost flow on the chronological order purchases are made, while the **LIFO** method bases it cost flow in a reverse chronological order. The average cost method produces a cost flow based on a weighted average of unit costs.

6.5 Comparing inventory costing methods

The choice of inventory costing method affects the balances of:

- Ending inventory,
- Cost of goods sold, and
- Gross and net profit.

During periods of rising prices, the **FIFO** method generally produces a larger ending inventory, a smaller cost of goods sold and a higher profit. During periods of rising prices, the **LIFO** method produces a smaller ending inventory, a larger cost of goods sold and a smaller profit. During periods of declining prices the effects of the two methods are reversed. The average cost method produces results that are in between the **LIFO** and **FIFO** methods.

6.6 Using non-cost methods to value inventory

Under certain circumstances, valuation of inventory based on cost is impractical. If the price of a good drops below the purchase price, the lower of cost or Net Realizable Value (NRV) method of valuation is recommended in IAS 2. This method allows declines in inventory value to be off-set against income of the period. When goods are damaged or obsolete, and can only be sold for below purchase prices, they should be recorded at NRV. The NRV is the estimated selling price less any expense incurred to dispose of the good.

6.7 Periodic versus perpetual inventory systems

There are fundamental differences for accounting and reporting merchandise inventory transactions under the periodic and perpetual inventory systems. To record purchases, the periodic system debits the Purchases account while the perpetual system debits the Merchandise Inventory account. To record sales, the perpetual system requires an extra entry to debit the Cost of goods sold and credit Merchandise Inventory. By recording the cost of goods sold for each sale, the perpetual inventory system alleviated the need for adjusting entries and calculation of the goods sold at the end of a financial period, both of which the periodic inventory system requires.

6.8 Inventory costing methods - perpetual

The perpetual inventory system requires that a separate inventory ledger be maintained for each good. Inventory ledgers provide detailed information on purchases, cost of goods sold, and inventory on hand. Each column gives information on quantity, unit cost, and total cost. When the average cost method is used, an average unit cost of each good is calculated each time a purchase is made. The advantages of the perpetual inventory system are a high degree of control, it aids in the management of proper inventory levels, and physical inventories can be easily compared. Whenever a shortage (i.e. a missing or stolen good) is discovered, the Inventory Shortages account should be debited.

6.9 Methods used to estimate inventory cost

In certain business operations, taking a physical inventory is impossible or impractical. In such a situation, it is necessary to estimate the inventory cost. Two very popular methods are:

- Retail inventory method, and
- Gross profit (or gross margin) method.

The retail inventory method uses a cost to retail price ratio. The physical inventory is valued at retail, and it is multiplied by the cost ratio (or percentage) to determine the estimated cost of the ending inventory.

The gross profit method uses the previous year's average gross profit margin (i.e. sales minus cost of goods sold divided by sales). Current year gross profit is estimated by multiplying current year sales by that gross profit margin, the current year cost of goods sold is estimated by subtracting the gross profit from sales, and the ending inventory is estimated by adding cost of goods sold to goods available for sale.

6.10 IAS 2 application

IAS 2 provides complete guidance for recording the cost of inventories and their subsequent disclosure in the financial statements. The inventories are valued against their **NRV** on the reporting date. Inventories are required to be stated at the lower of cost and **NRV** on the reporting date. (**IAS 2.9**)

UNIT 7: NON-CURRENTASSETS

7.1 Introduction

Non-current assets are assets that are held for a period exceeding one year and are used in business operations. Non-current assets are classified as tangible and intangible. Tangible non-current assets include land, buildings, equipment, furniture, plant, machinery and vehicles whereas intangible non-current assets include copy rights, goodwill, licenses, franchises, trademarks, etc.

When a tangible non-current asset is initially acquired, all costs incurred for acquisition and installation are debited to that particular asset account. Expenditures that are related to land can be debited to Land, Land Improvements, or Buildings depending upon how permanent they are and how long they are expected to last.

7.2 Depreciation

All non-current tangible assets, except land, depreciate over the time during which they are used. Factors that contribute to depreciation are physical and functional. Physical depreciation arises from the actual use of an asset. Functional depreciation is due to obsolescence factors such as technological advances and less demand for a product. The purpose of recording depreciation is to show the decline of usefulness of an asset, not a decline in its market value. Depreciation merely reduces the value of fixed asset accounts; it does not reduce the cash account or affect cash flows.

7.3 Determining depreciation

Factors that determine depreciation expense are the initial cost, the residual value and the useful life. Depreciation can only be estimated because it depends on several potentially changing elements. Residual value is any value that remains after an asset has been retired. The calculation of depreciation is based on the initial cost minus residual value. Several methods used to calculate depreciation. The straight-line method is the most popular. Different depreciation methods can be used for financial statement information and tax purposes.

7.4 Straight-line method

The straight-line method of depreciation charges equal amounts of depreciation to each period over the useful life of the asset. It is determined by subtracting the residual value from the initial cost and dividing it by the number of the years of estimated life. Due to its simplicity, it is the most widely used method.

7.5 Units-of-production method

The units-of-production method determines depreciation expense based on the amount the asset is used. The length of life of an asset is expressed in a form of productive capacity. The initial cost less any residual value is divided by productive capacity to determine a rate of unit-of-production depreciation per units of usage. Units of usage can be expressed in units of goods produced, hours used, number of cuttings, miles driven or tons hauled, for instance. The depreciation expense of a period is determined by multiplying usage by a fixed unit-of-production rate of usage. This depreciation method is commonly used when asset usage varies from year-to-year.

7.6 Declining-balance method

The declining-balance (a variation of this method is also known as double-declining-balance) method is a popular form of accelerated depreciating. This method does not consider the estimated salvage value in determining the depreciation rate or in computing the periodic depreciation. However, an asset cannot be depreciated beyond the estimated salvage value. Depreciation expense is highest in the first year, and becomes smaller each subsequent year.

7.7 Sum-of-the-years-digits method

The sum-of-the-years-digits method is a form of accelerated depreciation. The annual depreciation is calculated by subtracting salvage value from original cost, and multiplying this figure by a fractional rate of depreciation. The denominator of the fraction is the sum of the years of useful life; for a life of 4 years, the denominator is = 1 + 2 + 3 + 4 = 10. The numerator is the year in reverse order. For the first year, the numerator is 4 and the fraction is 4/10.

7.8 Composite-rate depreciation method

The composite-rate depreciation method determines depreciation of a group of similar plant assets by using a single rate. This rate is determined by dividing annual depreciation by the total original cost of assets. Although specific equipment in the group may be added and retired, this method assumes that the mix will remain unchanged. Gains and losses from the retirement or disposal of assets are not realized**.**

7.9 Comparing depreciation methods

Different depreciation methods produce different results, and in some circumstances the use of a particular depreciation method is recommended. When the use of an asset fluctuates from period to period, the units-of-production method is recommended. For assets that decline in usefulness early, and are subject to high maintenance costs as they age or used, a form of accelerated depreciation should be used, i.e. declining-balance and the sum-of-the-years- digits methods.

7.10 Depreciation & income taxes

Tax department may not agree with the method of depreciation used by a taxable business entity. Therefore, when a company files returns with them for the payment of tax liability for a given period of time, the depreciation is calculated again in the manner as prescribed in the tax law. Every country has its own tax law, therefore, the treatment of depreciation is also different in every country.

7.11 Revising depreciation estimates

Because depreciation is estimated, it often needs to be revised periodically over the life of the asset. An error in estimating the salvage value, the years of useful life, or both can require a revision. Previously recorded depreciation is not affected by a revision. The revision of depreciation only affects future depreciation expenses.

7.12 Recording depreciation expenses

When depreciation is to be recorded, a Depreciation Expense account is debited, and Accumulated Depreciation is credited. Accumulated Depreciation is a contra-asset account that decreases the value of plant assets. The use of a contra-asset account allows assets to be shown at cost, and thus allows easier computations if a revision is necessary or different depreciation methods are used. When an asset is sold, all accounts related to the depreciation of that asset are adjusted.

7.13 Capital & revenue expenditures

Expenditures on fixed assets fall into two categories:

- Capital expenditures: these increase the productive capacity, efficiency or useful life of an asset, and
- Revenue expenditures: these include maintenance and repairs.

If expenditure increases the efficiency or capacity of a fixed asset, that **fixed asset account** is debited. If expenditure increases the useful life of a plant asset, the **accumulated depreciation account** is debited. Revenue expenditures are expensed in the year incurred.

7.14 Disposing-off fixed assets

Fixed assets can be disposed of by discarding, selling, or trading in for other assets. No matter, how fixed assets are disposed-off, the book value of the asset must be removed from the account. When an asset becomes completely useless, it is written-off from the books by debiting the accumulated depreciation account and crediting the equipment account. In the event an asset is discarded before its estimated useful life, the loss must be debited to the loss on disposal of fixed assets account.

7.15 Trade-in of fixed assets

When a fixed asset is sold, cash and accumulated depreciation accounts are always debited, and equipment account is credited. In the event, there is a loss or gain from the sale, either the loss on disposal of fixed assets or the gain on disposal of fixed assets accounts will have an entry. When fixed assets are exchanged for new plant assets, it is generally accepted that any gains from a trade need not be recognized. The amount that is owed after credit for the trade-in is known as the boot, which is also the required cash payment. The entry is this situation is debit accumulated depreciation (old equipment) debit fixed assets (new equipment) credit fixed assets (old equipment) credit cash.

7.16 Subsidiary Ledgers for non-current assets

When a business has a large number of non-current assets to keep track of, the use of a Subsidiary Ledger is recommended. Detailed information on each non-current asset is maintained in the Subsidiary Ledger. All non-current assets can be specifically identified by an assigned number. The first part of the number corresponds to the General Ledger account, while the second part of the number represents the identification assigned to the asset. Periodically, it is advisable to compare balances of the Subsidiary Ledger with the controlling accounts in the General Ledger. Subsidiary Ledger is very useful in determining depreciation expenses, filing tax and insurance forms, as well as recording the disposal of plant assets.

7.17 Fixed Assets' Register

This is a list of fixed assets in summarized format. This book records fixed assets with every information pertaining to them but in a summary form. The book is prepared in addition to General Ledger and Subsidiary Ledger. The fixed asset register differs to General Ledger accounts and its Subsidiary Ledger in its contents. General Ledgers has every transaction in it. Whereas fixed asset register shows the summary of each fixed asset account on a given period of time. *Please refer to **Appendix A** for details of information given in a typical fixed asset register.* The purpose of the book is to track information pertaining to fixed asset quickly and accurately.

7.18 Leasing fixed assets

A business can rent a property for a specified period of time under a contract known as a lease. The lessor is the owner of the property, and the lessee is the party that has the right to use the property. Leases which extent over most of the asset life, and which transfer ownership to the lessee at the end of the lease are called capital leases. Assets held under capital lease must be shown on the balance sheet, and therefore, the assets account is debited and a lease liability account is credited. Operating leases tend to be more short-term, and the lessee does not acquire the leased property at the end of the lease.

7.19 Intangible assets

Intangible assets do not have physical substance. They are not held for sale, and they are usually highly valuable to the business. They include patents, copyrights, trademarks, goodwill, licenses, and franchises. Except for goodwill, most intangible assets receive legal protection for exclusive use. The cost of obtaining legal protection for the intangible asset should be debited to the intangible asset account. The periodic loss of value of the intangible asset is called amortization, and is expensed annually. Research and development costs are treated as expense in the year incurred and are not treated as intangible assets because their future success is uncertain.

7.20 Depletion

The periodic allocation of the use of natural resources is a called depletion. Mineral deposits, coal, timber, natural gas, and petroleum are all subject to depletion. Depletion Expense is debited and Accumulated Depletion is credited for the amount of usage during the period. The usage is based on current year production as a fraction of total capacity, and the determination is essentially identical to the unit-of-production depreciation method.

7.21 IAS 16 property plant & equipment application

IAS 16 provides guidance about recording cost of fixed assets and the disclosure requirements in financial statements.

UNIT 8: PAYROLL SYSTEM

8.1 Introduction

Payrolls represent the entire amount paid to all employees over a given accounting period. Because employees are very sensitive to payroll errors or any irregularities, payroll systems should assure accurate and timely payments. Accurate records are also required by federal and provincial government agencies. Payroll expenditures typically have a significant impact on the income statement of a company. Manual labor, whether skilled or unskilled receives remuneration in the form of wages. Wages are usually stated in terms of an hourly rate, weekly rate, or on a piecework basis.

DETERMINING EMPLOYEE EARNINGS

- **Earnings are computed by multiplying hours worked by an hourly rate.**
- **When hours worked is less than or equal to 40, Earnings = Hours x Rate (E = H x R).**
- **When an employee works more than forty hours and is entitled to time and a half for each hour worked over forty, the following formula should be used:**
  E = 40R + 1.5(H - 40).

Salaries are paid to those individuals that hold administrative, executive, managerial or sales positions. Their pay is usually stated on a monthly or annual basis. Salaries and wages are often supplemented by commissions, bonuses, cost-of-living adjustments, profit sharing and/or pension plans. Employers and employees typically meet and agree on a fair salary or wage rate.

8.2 Profit-sharing bonuses

Bonuses are usually based upon the productivity of an individual. Today's companies are relying less on salary and more on bonuses to attract and reward executives. Bonuses can be computed in several different ways, each yielding a different amount. The bonus percentage can be based on income:

- Before deducting the bonus and income taxes,
- After deducting the bonus, but before deducting income taxes,
- Before deducting the bonus, but after deducting income taxes, and
- After deducting the bonus and income taxes.

8.3 Employee earnings deductions

Gross pay is total earnings of an employee before any deductions. Net pay is the amount an employee receives after all deductions. Deductions are commonly made for federal, provincial, and local income taxes. Deductions can be made for voluntary items such as health insurance, charitable contributions, pension fund contributions and union dues.

8.4 Employer's payroll tax liabilities

Employers can be subject to both federal and provincial taxes based on the amount of compensation paid to their employees.

8.5 Payroll accounting systems

The three major components of a payroll system are:

- Payroll Register: it is used to assemble and summarize data for each payroll period,
- Employee's earnings record: it provides detailed information for each employee, and
- Payroll checks, direct ATM deposits or cash, usually accompanied by a statement showing all the deductions.

PAYROLL REGISTER

The Payroll Register is a multicolumn journal used to assemble and summarize payroll data. Information that can typically be found is the following: employee names, total hours worked, regular earnings, overtime earnings, total earnings, tax deductions, net amount paid, check number, and a debit to an expense account. Checks are recorded in the Payroll Register so no other records need to be maintained on payments. The accuracy of the Payroll Register can be determined by cross-verification of its columns. The regular and overtime pay columns should always be equal to the salary and wage expense columns.

8.6 Components of the payroll system

The Payroll Register consists of constant and variable elements. Wage rate are typical constant element. Hours worked vary. Information obtained from the Payroll Register is used for General Ledger entries, to issue payroll checks and statements, and to update employees' earnings records. Data from the employees' earnings records are used to prepare wage and tax statements and payroll tax returns. Entries recorded in the General Ledger are used to prepare the income statement and balance sheet.

8.7 Payroll system controls

Internal controls for payroll systems are similar to those for cash disbursements. A voucher system is recommended. When names are to be deleted or added to the Payroll Register, they should be supported by a written statement from personnel department. Attendance records are taken by personnel to ensure accurate determination of pay, vacation benefits and sick leave benefits. As an extra measure of safety, employee identification cards are often issued and must be presented by employees when receiving paychecks.

8.8 Liabilities for employee fringe benefits

Fringe benefits are non-monetary benefits enjoyed by an employee which are not subject to tax. These benefits are provided by employers to motivate workers to increase their efficiency. Fringe benefits commonly offered by employers are vacations, health insurance, pension plans, life insurance and disability insurance.

When employers agree to pay part or all of the costs of fringe benefits; they incur an expense and a liability. The cost of the fringe benefits should be properly matched to the period an employee has worked. If the employee has not received the fringe benefit, a liability remains. Depending on when the liability is expected to be paid, it may be classified as either short-term or long-term on the balance sheet.

8.9 Types of fringe benefits: Statutory & Non-statutory benefits

Statutory benefits may include leave with wages or salary, retirement and pension benefits, medical benefits, employment injury benefits, etc. Non-statutory benefits may include accommodation and educational facilities for the kids of an employee, recreation and benefits such as transport, etc.

8.10 IAS 19 & IAS 26 application

- Wages and salaries
- Compensated absences (paid vacation and sick leave)
- Profit sharing plans
- Bonuses
- Medical and life insurance benefits during employment
- Housing benefits
- Free or subsidized goods or services given to employees
- Pension benefits
- Post-employment medical and life insurance benefits
- Long-service or sabbatical leave
- 'Jubilee' benefits
- Deferred compensation programs
- Termination benefits.

UNIT 9: THE GOING CONCERN ASSUMPTION

9.1 Definition & its explanation

In the ordinary course, accounting assumes that the business will continue to exist and carry on its operations for an indefinite period in the future. The entity is assumed to remain in operation sufficiently long to carry out its objects and plans. The values attached to the assets will be on the basis of its current worth. The assumption is that the fixed assets are not intended for re-sale. Therefore, it may be contended that a statement of financial position (balance sheet) which is prepared on the basis of record of facts on historical costs cannot show the true or real worth of the concern at a particular date. The underlying principle there is that the earning power and not the cost is the basis for valuing a continuing business. The business is to continue indefinitely and the financial and accounting policies are followed to maintain the continuity of a business unit.

9.2 Examples of indicators of going concern problems

Operating Indicators

1. Lack of strategic direction, including well-documented policies, plans, and forecasts;
2. Deficiencies in the governing body, such as lack of independent members, or little involvement in key decisions;
3. Lack of management expertise or loss of key management personnel;
4. Loss of major market, license or franchise;
5. Prolonged industrial action;
6. Shortages of important supplies or loss of major suppliers;
7. Deficiencies in management information system;
8. Rapid or unplanned development of business without commensurate developments in support areas;
9. Un-insured or under-insured disasters such as droughts, fires, floods, frauds, or sabotage.

Financial Indications

1. High gearing or a net liability position;
2. Fixed-term borrowings nearing maturity without realistic prospects of renewal or repayment;
3. Reliance on short term borrowings to finance long-term assets;
4. Adverse key financial ratios;
5. Lack of sustainable operating profits or cash flows from core business activities;
6. Dividend arrears or discontinuance;
7. Inability to pay creditors on time;
8. Excessive reliance on transactions with related parties;
9. Potential losses on long term contracts or uneconomic long-term commitments;
10. Difficulty in complying with the terms of loan agreements or the need to restructure debt;

11. Denial of trade credit by suppliers;
12. Inability to obtain necessary financing;
13. Need to seek new sources or methods of financing or to dispose of substantial assets; and
14. Reduction in government funding.

Other Indications

1. Non-compliance with capital or statutory requirements;
2. Undue influence of a market-dominant competitors;
3. Legal proceedings against the entity that may result in judgments that could not be met or in restrictions on trading opportunities;
4. Technical developments which render a key product obsolete;
5. Adverse changes in legislations or government policy;
6. Failure of other entities in the same industry; and
7. Lack of adequate back-up and recovery capabilities for key information systems.

9.3 Examples of mitigating factors

Asset Factors

1. Disposability of assets that are not operationally interdependent;
2. Capability of delay the replacement of assets consumed in operation or to lease than purchase assets; and
3. Possibility of using assets for factoring or sale and leaseback.

Debt Factors

1. Availability of unused lines of credit or similar borrowing capacity;
2. Capability to renew or extend the due dates of existing loans; and
3. Possibility of entering into debt restructuring agreements.

Cost Factors

1. Separability of operations producing negative cash flows;
2. Capability of postponing expenditures such as maintenance or R & D;
3. Possibility of reducing expenditures on overheads and administration.

Equity Factors

1. Variability of dividend requirements;
2. Capability to obtain additional contributions by owners; and
3. Possibility of increasing cash distributions from subsidiaries.

APPENDIX A: HOW TO CREATE & MAINTAIN A FIXED ASSET REGISTER

Open the following columns for each asset in a fixed asset register:

1. An asset tracking number or asset code, which is a unique identification number. The physical asset is often marked with this identification number, either directly or with an asset tag.
2. The complete description of the asset like model, make, chassis #, etc. etc.
3. The quantity of asset acquired.
4. The asset is manufactured by the company should be given in detail.
5. The asset's serial number, which is the identification number assigned to the asset by its manufacturer.
6. Warranty coverage, which can be a simple yes/no indicator or a hyperlink to the warranty contract.
7. The warranty expiration dates of assets purchased (if any).
8. Insurance coverage of each asset according to company policy, which should be linked to a file containing the detailed insurance coverage.
9. The acquisition date of the asset.
10. The acquisition cost of the asset.
11. Capital expenditure made on the asset which prolonged its life and efficiency.
12. Any revision in the depreciation because of capital expenditure made on the asset
13. The date the asset was placed into service.
14. The percentages of use of asset for business purposes and mention if any other use of the asset is made.
15. The salvage value of each asset.
16. The asset's useful life as determined by the management, which is the period over which the asset will be depreciated.
17. The depreciation method used for each asset.
18. The current book value of each asset.
19. The physical location of the asset.
20. The date of disposal of each asset.

The End.